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IN THE

Supreme Court of the United States

October Term, 1948

No. 247

RAILWAY EXPRESS AGENCY, INCORPORATED,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

The petitioner, Railway Express Agency, Incorporated, prays that a writ of certiorari issue to review the judgment of the Circuit Court of Appeals for the Second Circuit entered in this proceeding.

OPINIONS BELOW

The opinion of The Tax Court of the United States (R. 4-39) is reported at 8 T. C. 991. The opinion of the Circuit Court of Appeals for the Second Circuit (R. 65-75) is not yet officially reported.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered July 19, 1948. (R. 75) Jurisdiction of this Court is invoked under section 240 of the Judicial Code, as amended by the Act of February 13, 1925 (U. S. C. A., Title 28, section 347 (a)) and under section 1141 (a) of the Internal Revenue Code (U. S. C. A., Title 26, section 1141(a)).

QUESTIONS PRESENTED

1. The petitioner is a railroad-owned, joint facility organized for the purpose of engaging in express transportation in its own name, but, nevertheless, acting in fact only as the agent of its railroad principals and accounting to them under the terms of an operating agreement for all of its revenues after payment of expenses. The petitioner has only a nominal capital stock of 1,000 shares of no par value. This stock is held by 70 Class 1 railroads and merely represents voting rights. Its operations are conducted under identical contracts with over 400 railroads, and the revenues are divided not as dividends but among all participating railroads, stockholders and non-stockholders alike, on the basis of their participation in the gross express business handled. The principal question presented is whether any part of the receipts of the petitioner from express operations for 1937 and 1938 constituted income taxable to it under the Revenue Acts of 1936 and 1938. Conversely, the question is whether the income from express operations in its entirety, whether distributed or not, belonged to and was taxable directly to the railroad principals under the agency contracts.

2. An alternative question is whether for 1937 the petitioner was entitled to the credit granted by section 26 (c) (1) of the Revenue Act of 1936 in the computation of the surtax upon undistributed net income imposed by section 14 of that Act.

SUMMARY STATEMENT OF FACTS

The petitioner is a corporation organized on December 7, 1928 as an integral part of a plan by which the railroads of the United States took over the express business of the country for their own account. (R. 10; Ex. 3-C, pp. 5-16)

Transition of express business from independent to railroad ownership

From September 1, 1920 until February 28, 1929, the express business of the country was handled by American Railway Express Company (hereinafter referred to as "American") under uniform contracts with practically all of the railroads in the United States. American operated as an independent company for its own account. (R. 6) At the time of the approval of that arrangement, two members of the Interstate Commerce Commission dissented. One of them stated "that the time has come when the carriers should give serious and further consideration to the question of conducting the express business themselves. * * * They should no longer permit outside agencies to transact it." (59 I. C. C. 459, 469)

The uniform contracts between American and the railroads contained a provision to the effect that if American did not continue express operations after their expiration on February 28, 1929, it would sell to each railroad at cost, less depreciation, all property of American used in the express business located on the lines of such railroad. (R. 8)

For some years prior to 1929, the railroads acting through appropriate committees had been making a detailed study of the future of the express business after the contractual relations with American should end on February 28, 1929. (R. 6) As a result, a "Report and Plan For Future Conduct of Express Business" was prepared, adopted and carried out. (Ex. 3-C) The object of the

Plan was declared to be as follows:

> "The object sought to be attained by the plan is to make the future express agency a railroad-owned joint facility engaging in express transportation in its own name, but nevertheless acting in fact only as the agent of its railroad principals and accounting to them under the terms of the operating agreement (Exhibit D) for all of its revenues after payment of expenses. This relationship will make the railroads transporters of express as they are of freight with a consequent like status before commissions and courts." [Ex. 3-C, p. 2]

The Report and Plan outlined the procedure to be followed, contained the legal forms to be executed, including a certificate of incorporation and by-laws for a new express agency and the form of a new operating agreement to be executed between all participating railroads and the new express agency. (Ex. 3-C)

Four individuals, being the presidents of the Pennsylvania, New York Central, Union Pacific and Santa Fe railroads, were designated as agents to carry the Plan into effect. (Ex. 3-C, p. 5) The most important steps taken by these individual agents were (1) the negotiation of an agreement with American for the purchase of its express properties and equipment for over $30,000,000 (R. 10) which was to be paid with borrowed money and which was to be repaid out of the express revenues of the future (R. 17), (2) the organization of the new express agency (the petitioner) (R. 10), (3) the securing of approval of the Plan by the Interstate Commerce Commission to the extent required by law (R. 11; 150 I. C. C. 423), and (4) the assignment of their rights under the agreement with American to the new express agency. (R. 10) Pursuant to this assignment, title to the properties of American was acquired in the name of the petitioner. (Ex. 3-C, pp. 57-58)

The capital structure, stockholdings and management of the petitioner

The capital of the petitioner is limited to 1,000 shares of no par value stock which was originally allotted to 86 Class 1 railroads at $100 per share upon the basis of the express business done by them in the past. Participation was thus limited because of the impracticability of joining the very large number of other roads which performed in the aggregate only about 2 per cent of the express business. The stock is non-transferable except to the petitioner or to a successor of the holder in the case of consolidation, merger or purchase. (R. 7-8)

The Plan provided that "the capital stock should not represent any substantial equity in the property but merely the voting rights" and that "the distribution of the stock does not affect the distribution of earnings from the express business, which will be distributed under and in accordance with the operating contract, rather than as dividends". (Ex. 3-C, p. 8)

The petitioner was managed by a Board consisting of 15 Directors, 14 of whom were selected by railroads from prescribed geographical groups and one selected at large. (R. 9)

The operating contract

At all times since March 1, 1929, petitioner has conducted the express business under separate identical contracts known as the Express Operations Agreement with substantially all the railroads of the United States. During 1937 and 1938 over 400 railroads, including 70 Class 1 railroads among which the 1,000 shares of capital stock were then distributed, were parties to that Agreement. (R. 11-12; Ex. 3-C, pp. 57-87)

The broad object of the Agreement was stated in the basic Plan as follows:

> "The new operating agreement is drafted with the object of making the several railroads, parties to it, common carriers of express shipments and principals in this respect, operating in the name of their common agent, the New Express Company. The Express Company will be in effect a joint facility agency, which, after deductions required for expenses and other charges, will distribute all revenues received by it among its principals. This will accomplish the change in the relationship of the railroads to the express business which has long been advocated by members of the Interstate Commerce Commission". [Ex.3-C, p.14]

The accounting between the petitioner and the railroads is specified in Article V of the Agreement. For the purpose of that accounting, the various items of income and deductions are as defined in what is known as the Uniform System of Accounts for Express Companies prescribed by the Interstate Commerce Commission in 1914. The railroads are divided into four geographical groups and with the exception of revenues from carload shipments, all accounting by the agency to the railroads is done on a group basis. The agency accounts directly to each railroad upon carload shipments for 85% of the gross revenues accruing on its lines. The remaining 15% from such carload shipments, all revenue from less than carload shipments and all other income is pooled for the benefit of the railroads in each particular group. (R. 12-13; Ex. 3-C, pp. 66-75)

Determinations of divisible revenue are made monthly. From the sum total of every conceivable type of income from all sources, there is deducted all expenses of operation, including depreciation on the physical properties. (R. 13) The balance is designated as "Rail Transportation Revenue" and is distributed monthly to the contracting railroads in each group in the proportion that the gross revenues earned on the lines of each such carrier bears to the gross express revenues earned on the lines of all such carriers in the group. (Ex. 3-C, pp. 73-74)

The Agreement contains various provisions for the adjustment of errors in the statement of any of the petitioner's accounts and for resolving disputes between the parties. (R. 15-16; Ex. 3-C, pp. 74, 80-81, 83-85) In many instances, the Agreement specifies as between the parties as to whether the petitioner and, therefore, all railroads in the group concerned or a particular railroad is to bear an item of expense or loss. (R. 17; Ex. 3-C, pp. 78-79, 81-82) No provision is made in the Agreement for compensating the petitioner for its services as agent. The petitioner has never paid any dividends to its stockholders. (R. 19)

The tax controversy

For each year since the beginning of the present arrangement, the petitioner filed a Federal income tax return. For the years 1929 to 1936, inclusive, it paid no taxes.[1] That means the Rail Transportation Revenue was taxed to the railroads and not to the petitioner. No question arose concerning the taxable status of the petitioner or the type of return it should file until 1937 and 1938 and for those years the Rail Transportation Revenue actually distributed in the amounts of $50,420,994.05 and $57,948,-646.62, respectively, were deducted by the petitioner and taxed to the carriers. (R. 21-22)

The present controversy arose out of a difference between the requirements of the Interstate Commerce Commission and of the Treasury concerning depreciation. In determining Rail Transportation Revenue, the Express Operations Agreement provides for the deduction of depreciation at the rates used on February 28, 1929 by the petitioner's predecessor or as fixed by the petitioner's Board of Directors or by the Interstate Commerce Com-

[1] This is undisputed at pages 77-78 of the typewritten transcript on file with the Circuit Court of Appeals. That transcript was not brought to this Court in connection with this petition for certiorari.

mission. (Ex. 3-C, p. 72) On May 19, 1936, the Interstate Commerce Commission issued an order directing that effective January 1, 1937 the petitioner shift from the unit method of accounting for depreciation to the group method as described therein. The group method was accordingly employed by the petitioner for 1937 and 1938 and this resulted in substantially increased depreciation deductions. The petitioner accounted to its contracting railroads on that basis. The same deductions for depreciation were taken in its Federal tax returns for 1937 and 1938. The Commissioner of Internal Revenue reduced these amounts to the extent of $383,994.07 and $274,779.70, respectively, and treated such amounts as income taxable to the petitioner. The deficiency asserted by the Commissioner resulted solely from that determination. The correct depreciation for tax purposes is not in dispute.[2] (R. 19-20, 52)

Although the deficiency asserted by the Commissioner resulted solely from the depreciation adjustment, two other items were placed in issue. In 1937 and 1938, the agency paid small amounts as fines for violations of municipal ordinances, customs regulations, etc. Capital losses were also incurred on sales of property. (R. 20) While these fines, in their entirety, and the net capital losses in excess of $2,000 were non-deductible for tax purposes, they were, nevertheless, deducted in full by the petitioner in computing Rail Transportation Revenue. In other words, in the initial accounting between the petitioner and the railroads, the agency was permitted to restore out of gross express revenues the amount of these fines paid and the capital

[2] Because of the conflict between the requirements of the Interstate Commerce Commission and the Treasury, the Commission by two orders in 1945 vacated its earlier order and granted permission to the agency to account for depreciation by including in its accounts amounts found by the Bureau of Internal Revenue to be allowable, and it also granted permission to restate the accounts in this manner retroactively to January 1, 1937. No retroactive action has, as yet, been taken under these orders because of the pendency of this proceeding. (R. 20, 54-55)

losses incurred. These restored amounts make up the entire income reported by the petitioner in its returns for 1937 and 1938. Since these two classes of income are in exactly the same category as the disallowed depreciation, the petitioner challenged the correctness, not only of the Commissioner's determination with respect to the disallowed depreciation, but also the correctness of the returns filed.

Contention of petitioner

Petitioner contends that it is the mere agent of its railroad principals, that the express business, the property used therein and the income therefrom belong to the railroads and that the burden of tax upon all income however arising under the Express Operations Agreement must fall directly upon the railroads and not upon their common agent. It should report to the Treasury as a fiduciary showing (1) the annual financial results of its operations, and (2) the distributable shares of express revenues belonging to each railroad whether distributed or not.

The decision of The Tax Court

The Tax Court in an unreviewed opinion by a single judge concluded that the revenues from the express business distributed to the railroads by petitioner were compensation for services rendered by them to petitioner and not a mere division of the profits from the railroads' business (R. 29); that the petitioner was the absolute owner of the properties utilized in the express business (R. 26); and that it occupied the relationship with the railroads of an independent contractor with income of its own (R. 30). The petitioner was accordingly held taxable in full upon the income here in question. (R. 32, 37) The alternative issue was decided in favor of the petitioner. (R. 37-39) Both parties appealed.

The decision of the Circuit Court of Appeals

The Circuit Court of Appeals affirmed with respect to the main issue and by a divided court reversed with respect to the alternative issue. After stating the contentions of the parties and without deciding whether a true principal and agency relationship existed, the court concluded that its earlier decision in *Commissioner v. National Carbide Corporation*, 167 F. (2d) 304, was "squarely to the contrary of the position taken by the Agency". (R. 69) Following this disposition of the issue, the court recited with approval some of the reasoning of the Tax Court and further concluded that "the depreciation items were deducted by the Agency for its own benefit as the owner of depreciating property" and that it was taxable upon the excess of the amount deducted in its accounting to the railroads over that allowable for tax purposes. (R. 70-71) In connection with the alternative issue, the court described this excess as a "windfall" to the agency. (R. 73)

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

1. In holding that amounts deducted by the petitioner in its accounting to the railroads, which are not deductible in computing net income under the revenue laws, belonged to the petitioner and are taxable to it.

2. In holding in effect that a true principal and agency relationship does not exist between the petitioner and the railroads, parties to the Express Operations Agreement.

3. In holding that a corporation is taxable upon the net income from its operations, regardless of the fact that it is but an agent and that as such its receipts belong to its principals.

4. In holding that in computing undistributed net income for the purpose of the surtax imposed by section 14

of the Revenue Act of 1936, petitioner was not entitled to the credit granted by section 26 (c)(1) of that Act.

REASONS FOR GRANTING THE WRIT

1. To the extent that the Circuit Court of Appeals held that the petitioner is not the common agent of the railroads, its decision is in conflict with the decision of the Circuit Court of Appeals for the Seventh Circuit in *Bowles v. Railway Express Agency, Inc.*, 65 F. Supp. 852, *aff'd., sub nom. Fleming v. Railway Express Agency, Inc.*, 161 F. (2d) 659 (1947).

The principal basis for the decision below was the court's reliance upon *Commissioner v. National Carbide Corporation*, 167 F. (2d) 304 (C. C. A. 2), which is now pending in this Court on a petition for certiorari (No. 151). However, the court went further and held that the income in question belonged to the petitioner. (R. 71) The legal effect of that conclusion is that the petitioner is not a mere agent of the railroads but occupies a position under the operating contract by which it can divert receipts to its own uses and to its stockholders as such. The petitioner having served the railroads for nearly 20 years disclaims any such authority.

The legal relationship between the petitioner and the railroads was squarely raised in *Bowles v. Railway Express Agency, Inc.*, 65 F. Supp. 852. There, the Price Administrator brought suit against the agency for treble damages and for an injunction claiming that the rate paid to the agency by the Illinois Central Railroad for certain miscellaneous freight services violated the maximum price regulations. The agency contended that the services performed by it did not constitute the sale of services for a price. The court dismissed the complaint holding that the services were rendered as agent and not as a seller. In so holding, the district court said:

> "It is the opinion of the court that the defendant, the agent of the railroads subscribing to the Express Operations Agreement for the conduct of the express transportation business and for the collection and distribution of the revenues accruing therefrom (Article II, Sec. 1 of the Agreement) is likewise the agent of the carriers in the performance of the miscellaneous transportation services pertinent to this case. The defendant has a paid-in capital of $100,000. It has neither a paid-in nor an undistributed surplus. Yet it did a gross business for the year ending on December 31, 1943 of over $350,000,000. The capitalization thus is purely nominal. The defendant does not stand on its own feet as a financially independent corporation, but draws its strength from the fact of its being the exclusive agent of the subscribing railroads in the express transportation business. Its revenues, after items of expense are deducted, are distributed to the subscribing railroads in proportion to their share of the total express business carried on their lines. The Agency is thus a kind of cooperative, although its membership is not the sort contemplated by the Rochdale pioneers. The relationship between a cooperative and its members is generally regarded as one of agency. Bowles v. Inland Empire Dairy Association, D. C. Wash., 1943, 53 F. Supp. 210, and cases cited therein." [65 F. Supp. 852, 854]

On appeal, the Circuit Court of Appeals for the Seventh Circuit affirmed and, as to the agency issue, adopted as its own the decision of the district court. (*Fleming v. Railway Express Agency, Inc.*, 161 F. (2d) 659) If, as that case holds, the petitioner is but an agent so far as the Emergency Price Control Act is concerned, it is likewise an agent for other purposes. The tax laws have added nothing to the law of agency.

To the extent that the court below held that a true principal and agency relationship does not exist between the railroads and the petitioner, its decision is in conflict with the plan under which the railroads took over the express business in 1929. The Legal Committee that drafted the

Plan stated that the object was "to make the future express agency a railroad-owned joint facility engaging in express transportation in its own name, but nevertheless acting in fact only as the agent of its railroad principals and accounting to them under the terms of the operating agreement * * * for all of its revenues after payment of expenses". (Ex. 3-C, p. 2) In submitting the new operating agreement, the Committee again stated that the agreement was drafted "with the object of making the several railroads, parties to it, common carriers of express shipments and principals in this respect, operating in the name of their common agent, the New Express Company". (Ex. 3-C, p. 14) The decision below holds in effect that the railroads failed in their main objective.

That it was intended that the properties acquired from American and taken in the name of the petitioner nevertheless belonged to the railroads is shown by the first recital of the operating agreement as follows:

> "WHEREAS, the Rail Company has united with other carriers operating railroads in the continental United States to acquire through their own express agency the properties of the American Railway Express Company employed in the express business, and to conduct through such express agency the future operations of the express business;" [Ex. 3-C, pp. 57-58]

The Interstate Commerce Commission thought that the role designed for the New Express Company was that of an agent. (*Securities and Acquisition of Control of Railway Express Agency, Inc.*, 150 I. C. C. 423, 429 (1929); *Railway Express Agency, Inc., Determination of Status*, 21 M. C. C. 161, 163 (1939))

To the extent that the court below held that a true principal and agency relationship does not exist between the railroads and the petitioner, its decision is in conflict with an Arbitrators' Decision rendered on July 15, 1948, by

Judge Kimbrough Stone, John W. Davis, and Justice Owen J. Roberts *In the Matter of The Arbitration of Disputes Under Railway Express Operations Agreement.*[3] That proceeding involved the arbitration of conflicting contentions of a large number of railroads arising out of the administration of the Express Operations Agreement during the war. The arbitrators found that the agency was the common agent of the railroads. (Pp. 3, 15, 16, 23, 29 and 41) In fact, some of the issues raised by several of the railroads, such as "Account Stated", "Voluntary Payment", and "Laches", were disposed of by the application of the law of agency. The Santa Fe Railroad presented a separate claim for damages on account of diversions of traffic from its lines. In denying this claim, the arbitrators said, in part: "The Agency has no funds of its own. As agent it holds any monies remaining after the payment of its expenses, for distribution amongst the carriers." (P. 41) This is directly contrary to the decision below that the petitioner acquired for its own benefit a "windfall" by reason of excessive deductions for depreciation. (R. 73)

Thus, despite the implication to the contrary contained in the opinion below (R. 70-71), there is squarely involved here the legal effect taxwise of a principal and agency relationship between two or more corporations. This in turn involves the correctness and applicability of the sweeping rule announced by the court below in *Commissioner v. National Carbide Corporation*, 167 F. (2d) 304, which the court applied in the instant case.

2. The legal effect in tax cases of a bona fide principal and agency relationship between two or more corporations is a matter of public importance in the administration of the tax laws which should be settled by this Court.

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[3] Since the Arbitrators' Decision is not reported, copies have been filed with the Clerk as an appendix to this petition.

In 1943, this Court in *Moline Properties, Inc., v. Commissioner,* 319 U. S. 436, and in *Interstate Transit Lines v. Commissioner,* 319 U. S. 590, granted certiorari because of uncertainties in the area of important federal tax law involved therein.

Moline Properties, Inc., v. Commissioner, supra, involved a contention that the entity of a corporation should be disregarded. In refusing to disregard the corporate entity, this Court pointed out that "there was no actual contract of agency, nor the usual incidents of an agency relationship". (P. 440) This Court there implied that the result might have been affected by such a relationship. At least, this Court left the question open.

Interstate Transit Lines v. Commissioner, supra, involved the effect of a contract by which a wholly-owned subsidiary corporation agreed to operate solely for its parent's benefit and the parent was to receive all profits and to reimburse for any deficits. Both the majority and dissenting opinions recognized that the contract should be given effect for tax purposes. The majority decision disallowed the taxpayer's claim for the deduction of a deficit paid for one year because of a defect in proof. The three dissenting justices would have allowed the deduction because the agreement was found to be a common-sense business arrangement not entered into for the purpose of avoiding taxes.

The court below in *Commissioner v. National Carbide Corporation,* 167 F. (2d) 304, contrary to the implications of the decisions of this Court referred to above, held broadly that where for business reasons a corporation is used it is taxable upon the income from its operations regardless of a principal and agency, or other contractual relationship between that corporation and its parent. The court below held that its decision in that case was squarely contrary to the position taken by the agency in the instant case. The *National Carbide Cor-*

poration case is pending in this Court on a petition for certiorari (No. 151), filed July 14, 1948. The importance of the question raised by that decision is concisely stated at pages 10 to 14 of the petition there filed.

The effect to be given in tax cases to a principal and agency relationship between two or more corporations is more squarely presented in this case than in the *National Carbide Corporation* case. That case, as did the cases of *Southern Pacific Co. v. Lowe*, 247 U. S. 330, *Moline Properties, Inc., v. Commissioner, supra,* and *Interstate Transit Lines v. Commissioner, supra,* in this Court, involved a relationship between a parent and wholly-owned subsidiaries. In such cases, it may be argued that since the parent is entitled to the earnings of its wholly-owned subsidiary by virtue of its stock ownership, the diversion of earnings by a contract not entered into at arms' length should not be permitted. (*Cf., Higgins v. Smith,* 308 U. S. 473.) Here, however, the petitioner's nominal stock is held by 70 railroads and merely represents voting rights. Under the Express Operations Agreement, it is the common agent of over 400 competing railroads. As between the railroads, parties to the joint venture, it was an arms' length arrangement. The earnings of the express business are divided, not as dividends, but among all participating railroads on the basis of the proportion of the total business handled over their lines.

In the application of the tax laws, this Court, so far as we are advised, has never refused to give legal effect to a bona fide contractual relationship under such circumstances. As shown above, the implications of its decisions are to the contrary.

3. The taxable status of the arrangement between the petitioner and over 400 railroads, under which substantially all the express business of the country is handled, is of itself a matter of public importance which should be settled by this Court.

The decision below, instead of clarifying the taxable status of the petitioner, leaves the matter in a state of uncertainty and confusion. The gross receipts from the express business have ranged from $163,091,039 in 1937 to $443,925,140 in 1947. For the years 1937 and 1938, there was divided among the carriers as Rail Transportation Revenue under the terms of the contract $50,420,996.05 and $57,948,946.62, respectively. (R. 22) These amounts were taxed to the carriers and not to the petitioner. In fact, it will not be disputed that in all years from 1929 to date the Commissioner has treated Rail Transportation Revenue in this manner. Admittedly, such revenue is not distributed as dividends. (R. 19) Under the *National Carbide Corporation* case, which the court held applicable here, all receipts by a corporation, regardless of its contractual obligations to the contrary, must be treated as gross income belonging to it for tax purposes. If the receipts of the express business are treated as gross income belonging to the petitioner, then it must find specific statutory authority for any deductions therefrom and such provisions are strictly construed. (*Interstate Transit Lines v. Commissioner,* 319 U. S. 590, 594)

The Tax Court taking cognizance of this problem suggested that the divisible Rail Transportation Revenue might be deducted as business expenses and paid as compensation for the services rendered by the railroads to the petitioner. (R. 22) This wholly unrealistic approach implies that the express business belongs to the petitioner and not to the railroads, and that the petitioner is an independent contractor and not an agent. The Circuit Court of Appeals, however, by applying the sweeping rule, announced in the *National Carbide Corporation* case, holds in effect that the receipts of the express business constitute gross income of the petitioner, even if a principal and agency relationship does exist. If such a relationship exists, then the amounts distributed by the petitioner con-

stitute payments by an agent accounting to its principals and not business expenses in the form of compensation to the railroads for services rendered by them to the petitioner.

4. If the petition for a writ of certiorari is granted, its scope should not be limited. This Court should keep open for review, the alternative issue decided by the court below, namely whether the petitioner was prohibited by a written contract from distributing dividends so as to entitle it to the credit granted by section 26 (c)(1) of the Revenue Act of 1936. This issue becomes material only if it is held that petitioner realized taxable income for 1937. For the reasons stated by The Tax Court (R. 37-39) and by Judge Learned Hand in his dissenting opinion (R. 74-75) the petitioner was prohibited by Article V, Section 4(i) of the Express Operations Agreement from distributing any part of its earnings as dividends. (R. 59; Ex. 3-C, pp. 72-73)

CONCLUSION

This petition for certiorari should be considered in connection with the pending petition in the *National Carbide Corporation* case (No. 151). Both petitions should be granted and the cases should be argued together.

Respectfully submitted,

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In the Supreme Court of the United States

OCTOBER TERM, 1948

No. 247

RAILWAY EXPRESS AGENCY, INCORPORATED,
PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 4-39) are reported at 8 T. C. 991. The opinion of the Court of Appeals (R. 65-75) is not yet officially reported.

JURISDICTION

The judgment of the Court of Appeals (R. 75-76) was entered July 19, 1948. The petition for a writ of certiorari was filed on August 27, 1948. The jurisdiction of this Court is invoked under 28 U.S.C., Sec. 1254.

QUESTIONS PRESENTED

1. The taxpayer is a regularly organized corporation, owning valuable assets and employing officers and employees, and engaging in express transportation in its own name. Its operations are conducted under identical contracts with over 400 railroads. Under these contracts the taxpayer collects its revenues from the public and after deducting its expenses and other items it distributes the balance as "Rail Transportation Revenue" to the contracting railroads as compensation for their transportation of express shipments for the taxpayer. All but a fraction of "Rail Transportation Revenue" is distributed to the 70 Class 1 railroads which own all of the taxpayer's stock. The principal question presented is whether the Court of Appeals was correct in holding that the taxpayer was taxable on that portion of its receipts less expenses which was not distributed to the railroads.

2. In the event the first question is answered in the affirmative, the further question is whether the Court of Appeals was correct in holding that the taxpayer was not entitled to a credit under Section 26 (c) (1) of the Revenue Act of 1936 in computing the surtax on undistributed profits for the year 1937.

STATUTES AND REGULATIONS INVOLVED

The applicable provisions of the statutes and regulations involved are set forth in the Appendix, *infra*, pp. 16-19.

STATEMENT

Although the Tax Court's findings of fact are extensive (R. 5-22) the pertinent facts may be summarized as follows:

Prior to 1929, a nation-wide express service had been performed under uniform contracts with the railroads by the American Railway Express Company, an independent company. In anticipation of the termination of contractual relations with American, a committee representing the railroads prepared a detailed plan for the carrying on of the express business after February 28, 1929. (R. 6.) The plan as ultimately adopted provided for the organization of a new express company by the 86 railroads which handled approximately 98 per cent of the gross express business on all railroads. (R. 7-8.) Accordingly, the taxpayer was incorporated in Delaware on December 7, 1928. Its corporate powers are quite broad, covering activities much more extensive than the express business. (R. 10-11.) It had an authorized capital stock of 1,000 shares without par value which was issued to the 86 railroads on the basis of the express business done by them in the past. (R. 7.) Subsequently, by reason of various mergers and consolidations of some of its stockholders, the number of stockholders was reduced to 70 railroad companies by the end of 1938. (R. 11.)

In order to obtain funds for the purchase of the property of American, the taxpayer issued $32,000,000 of five per cent bonds under a trust inden-

ture. These bonds were sold to underwriters who sold them to the public. The rights of the taxpayer under its contracts with the railroads were pledged in the trust indenture as security for the payment of the bonds and interest thereon, as to which the taxpayer was solely liable. The indenture further provided that the taxpayer would not mortgage or pledge its rights under the contracts with the railroads except in subordination to the lien of the indenture. The indenture made all indebtedness of the taxpayer subordinate to the bonds to be issued thereunder. It contained an agreement on the part of the taxpayer not to modify the agreements with the railroads without the written consent of the trustee, as well as a provision, in case of default by the obligor, for operation or sale of the property for the benefit of the bondholders. (R. 17-18.)

The taxpayer has operated its express business under separate identical contracts, called "Express Operations Agreements", with substantially all of the railroad companies in the United States. During the tax years in controversy, over 400 railroads, including those which were stockholders, were parties with the taxpayer to such Express Operations Agreements. These agreements, which expire February 28, 1954, designated the taxpayer as the exclusive agent of the railroads for the conduct of the express transportation business and for the collection, disbursement and division of revenue accruing under the agreements. The taxpayer was,

however, authorized to file tariffs and other rules and regulations with the Interstate Commerce Commission on its own behalf and on behalf of the railroads. (R. 11-12.) Moreover, as between the taxpayer and the railroads, the former was liable for loss to its own property and for injury to its own employees and agents. (R. 17.) Nothing in the agreements limited the right of the taxpayer to appoint and exercise control over its employees. Provision was made for the arbitration of disputes on request, resort to such arbitration being a condition precedent to any further action. (R. 16.)

The terms of the agreements fixed the amounts payable by the taxpayer to the contracting railroads as, in short, gross revenue less expenses. The agreements contemplated that all of the taxpayer's income and expenses, as defined therein, including depreciation, should be taken into account in arriving at the amount distributable to the railroads, each of which was to receive a share proportionate to the amount of express business it had handled on its line. The amount distributable to the railroads was termed "Rail Transportation Revenue". The deductions allowed the taxpayer in computing "Rail Transportation Revenue" were particularized. Thus the taxpayer was authorized to deduct from the moneys received by it certain items that were designated as net income items, including appropriations from "net income" for investment in physical property. Also certain "surplus" items could be deducted, including "sur-

plus set aside for investment in physical property." (R. 12-15.)

During 1937 and 1938 in determining "Rail Transportation Revenue", the taxpayer deducted from its income those charges and items of expense which were provided for in its agreements with the railroads. Included therein were deductions for depreciation aggregating some $2,000,000 for each year, computed in the manner as ordered by the Interstate Commerce Commission. The balance it distributed among the railroads with which it had agreements. These depreciation allowances were claimed as deductions in its returns for 1937 and 1938. The Commissioner ruled that these deductions for depreciation were excessive in amounts aggregating over $600,000 and accordingly he determined the deficiences involved herein. There is no dispute as to the propriety of the Commissioner's action in reducing the depreciation deductions. (R. 19-20.)

The taxpayer's returns for 1937 and 1938 showed income and excess profits taxes due in amounts aggregating some $25,000. The taxpayer has paid these taxes. (R. 21.) In 1945 the taxpayer obtained from the Interstate Commerce Commission permission, retroactive to January 1, 1937, to account for depreciation charges on the basis found by the Commissioner. However, the taxpayer has as yet taken no action upon this permission in view of the pendency of these proceedings. (R. 20.)

The Tax Court sustained the Commissioner's determination of deficiencies based on excessive depreciation deductions, but reduced the 1937 income tax deficiency on the ground that the taxpayer is entitled to a credit under Section 26 (c)(1) of the Revenue Act of 1936 (Appendix, *infra*) in computing the surtax on undistributed profits for the year 1937. (R. 22-39.) The Court of Appeals affirmed the Tax Court's holding that the taxpayer is taxable on the excessive depreciation it claimed as well as on the net income it reported in its returns. However, the Court of Appeals, one judge dissenting, reversed the Tax Court on the credit issue. (R. 66-75.)

ARGUMENT

1. Both the Tax Court and the court below held that the amounts determined by the Commissioner as excessive depreciation must be treated as income taxable to the taxpayer. The taxpayer contends that under the Express Operations Agreement it is only the agent of the railroads and that, therefore, all of its income from express operations is taxable only to the railroads which are parties to the agreement. The facts as to the manner in which the taxpayer has conducted its business and determines the Rail Transportation Revenue payable to the railroads clearly support the decision below.

The taxpayer is a regularly organized corporation carrying on a type of business which is engaged in for profit by many corporations such as trucking companies. In fact, the taxpayer's ex-

tensive business was for many years conducted by the American Railway Express Company for its own account and for profit. The taxpayer has broad corporate powers and holds title in its own name to millions of dollars worth of real and personal property which it uses in its business. The acquisition of the taxpayer's properties from American was financed almost entirely from the proceeds of the taxpayer's interest-bearing bonds which were sold to the public and secured only by the taxpayer's assets and earning power. The taxpayer has complete control over its own employees, and is solely responsible for its obligations. Here is no corporate shell or a mere department of a larger integrated business, but rather a genuine enterprise with its separate assets, revenues, employees and accounts.

The taxpayer paid over to the railroads for each of the years 1937 and 1938 in excess of $50,000,000 in "Rail Transportation Revenue", the taxability of which is not in issue. What is important here is that under its contracts with the railroads, the taxpayer was given considerable latitude in computing "Rail Transportation Revenue". For example, it was authorized to deduct amounts representing "surplus set aside for investment in physical property." Of particular relevance, the taxpayer's authority to make deductions for depreciation was not limited to the amounts allowable for tax purposes. Thus, as the court below pointed out, the taxpayer's contracts with the railroads enabled it

at its option "to increase its physical properties out of funds which would otherwise be distributable to the contracting railroads" (R. 71).

In the light of these facts, the Tax Court and the court below were clearly correct in finding that no principal-agent relationship existed between the taxpayer and the railroads. Furthermore, under common law agency concepts, the agent must possess power to alter legal relationships between the principal and third persons. *Restatement of the Law of Agency*, section 12. The taxpayer here, by agreeing to use its own property and organization in carrying on its own business with the public, was not granted any authority to create and alter legal relationships between the railroads and anyone else. Consequently, no principal-agency relationship was created.

The decision below was required by established legal principles. The economic earner of income cannot render himself immune from taxation by agreeing that another shall be the "owner" of the income which is produced by the former's property and services, and by denominating the parties "principal" and "agent". Facts, rather than labels, determine tax liability. *Griffiths* v. *Commissioner*, 308 U. S. 355; *Higgins* v. *Smith*, 308 U. S. 473; *United States* v. *Joliet & Chicago R. Co.*, 315 U. S. 44. Where, as here, there is no true principal-agent relationship, calling a corporation the agent of its several stockholders is only another manner of contending that the corporate entity

should be disregarded. *Moline Properties* v. *Commissioner*, 319 U. S. 436, 440-441.

The taxpayer seeks (Pet. 16) to distinguish the present case from *Moline Properties* v. *Commissioner*, *supra*, and similar cases in which this Court has refused to disregard for tax purposes the corporate entity of a wholly owned subsidiary. It argues that since its "nominal stock" is held by only 70 of the more than 400 contracting railroads, the Express Operations Agreement was "an arms' length arrangement" and that hence the earnings of the express business are not distributed as dividends. Suffice it to say that *Moline Properties* v. *Commissioner* did not turn on the narrow question whether the distribution of the wholly owned subsidiary's income to the parent was tantamount to the payment of dividends. Too, from a factual standpoint, the taxpayer's argument loses force when it is recalled that the 70 stockholding railroads are Class 1 railroads which receive all but a small fraction of the "Rail Transportation Revenue" which is distributed by the taxpayer to the contracting railroads.[1]

That the taxpayer did in fact retain as surplus at least the amounts of excessive depreciation, totalling nearly two-thirds of a million dollars, cannot be contradicted. In the hands of taxpayers generally

[1] In 1928, the year the taxpayer was incorporated, the stockholding railroads performed about 98 per cent of the gross business transacted under the contracts with taxpayer's predecessor. (R. 7-8). There is no indication in the record that this percentage has decreased since 1928.

such amounts are obviously taxable income. Although the taxpayer obtained from the Interstate Commerce Commission, some seven years after the close of the taxable period here involved, *permission* to account for depreciation charges by including in its accounts amounts found by the Commissioner to be allowable, no such adjustments have in fact been made in "Rail Transportation Revenue." And even if these adjustments are made at some future time, they would be the result of a voluntary action on the part of the taxpayer. The relinquishment of income under such circumstances does not alter the incidence of taxation. *Corliss* v. *Bowers*, 281 U. S. 376, 378.

2. There is no conflict in decisions. The taxpayer (Pet. 11-12) urges that *Bowles* v. *Railway Express Agency*, 65 F. Supp. 852 (N.D. Ill.), affirmed *sub nom. Fleming* v. *Railway Express Agency*, 161 F. 2d 659 (C.C.A. 7th), is irreconcilable with the conclusion of the court below. However, the Tax Court carefully considered that contention and rejected it on the ground, among others, that the court in *Bowles* v. *Railway Express Agency* expressly pointed out that its decision did not relate to tax liability. (R. 30.) It is quite understandable, therefore, that the Court of Appeals took no further notice of the contention.

The views of the Tax Court with respect to *Bowles* v. *Railway Express Agency* apply in large measure to the Arbitrators' Decision of July 15,

1948, which the taxpayer (Pet. 13-14) says is directly contrary to the decision below. The Arbitrators' Decision related primarily to accounting methods employed by the taxpayer in computing the distributable shares of "Rail Transportation Revenue", and specifically to an agreement (the Economy Plan) supplementary to the Express Operations Agreement. The taxpayer's right to make deductions of amounts to be retained by it was not there involved. That the Economy Plan has no bearing on this tax controversy is adequately demonstrated by the taxpayer's failure to refer to it heretofore in this litigation. Moreover, the Decision makes no reference whatever to this taxpayer's liability under the taxing statute.

The taxpayer (Pet. 13) also seeks to establish a conflict between the decision below and rulings made by the Interstate Commerce Commission. But as the Tax Court pointed out (R. 31-32), the taxpayer is "required to account for its gross income pursuant to provisions of the applicable revenue act, and in doing so, disregard, if necessary, accounting rules prescribed by the Interstate Commerce Commission", citing *Old Colony R. Co.* v. *Commissioner,* 284 U. S. 552.

Stating (Pet. 16) that this Court "has never refused to give legal effect to a bona fide contractual relationship under such circumstances", the taxpayer makes a broad claim to a conflict with other decisions of this Court, without citing them. This Court has repeatedly looked at the substance rather

than the form of agreements in taxing income to him who earns it.

3. The decision below need not be disturbed, irrespective of this Court's disposition of *National Carbide Corp.* v. *Commissioner,* No. 151, and related cases. As the Court of Appeals stated (R. 70), "this case seems yet more clearly against this taxpayer than did that [National Carbide]", pointing out many elements of the relationship between the taxpayer and the railroads not present in that case. In *National Carbide* the wholly-owned subsidiary admittedly was taxable on the nominal amount it *retained* as compensation; the controversy there related to the amounts *paid over* to the parent. For present purposes, it is unnecessary to draw a parallel between the "Rail Transportation Revenue" the taxpayer here distributed to the railroads and the amounts paid over to the parent by National Carbide; the taxability of the amounts *retained* by the taxpayers in both cases cannot be seriously questioned. Thus it is clear that while the decision below is consistent with and supported by *National Carbide,* this case can stand alone.

4. There is no occasion for this Court to review the decision of the court below with respect to the undistributed profits surtax credit provided by Section 26 (c) (1) of the Revenue Act of 1936 for earnings which cannot be distributed as dividends without violating a written contract. The taxpayer's Express Operations Agreement with the

railroads requires the taxpayer to pay over to the railroads, in proportion to the amounts of express business handled by each, all of its income minus certain specified classes of deductions. The Agreement specifically excludes dividend disbursements from such authorized deductions. The Court of Appeals, with L. Hand, J., dissenting, held that the payment of dividends out of the sums retained by the taxpayer as excessive depreciation deductions would not violate the Agreement. In thus holding that the taxpayer is not entitled to this credit, the Court of Appeals correctly applied the decisions of this Court in *Helvering* v. *Northwest Steel Mills*, 311 U. S. 46, and *Helvering* v. *Ohio Leather Co.*, 317 U. S. 102, to the facts in this case.

5. This case is not a matter of such public importance as to require that it be heard by this Court, as the taxpayer contends (Pet. 16-18). The Commissioner is not seeking to tax this taxpayer on the "Rail Transportation Revenue", exceeding $50,000,000 in each of the years 1937 and 1938, which was distributed to the railroads. Only the relatively nominal amounts of income over expenses which the taxpayer *retained* are involved in these proceedings. Were the Commissioner seeking to tax "Rail Transportation Revenue", the taxpayer would then have cause to apprehend that "substantially all the express business of the country" (Pet. 16) would be affected by the outcome of this case.

CONCLUSION

There is no conflict of decisions. The case was correctly decided by the court below in accordance with the controlling decisions of this Court. The petition for a writ of certiorari should be denied.

Respectfully submitted,

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SEPTEMBER, 1948.

APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 14. SURTAX ON UNDISTRIBUTED PROFITS.

(a) *Definitions.*—As used in this title—

(1) The term "adjusted net income" means the net income minus the sum of—

(A) The normal tax imposed by section 13.

(B) The credit provided in section 26 (a), relating to interest on certain obligations of the United States and Government corporations.

(C) In the case of a holding company affiliate (as defined in section 2 of the Banking Act of 1933), the amount allowed as a credit under section 26 (d).

(D) In the case of a national mortgage association created under Title III of the National Housing Act, the amount allowed as a credit under section 26 (e).

(2) The term "undistributed net income" means the adjusted net income minus the sum of the dividends paid credit provided in section 27 and the credit provided in section 26 (c), relating to contracts restricting dividends.

(b) *Imposition of Tax.*—There shall be levied, collected, and paid for each taxable year upon the net income of every corporation a surtax equal to the sum of the following, subject to the application of the specific credit as provided in subsection (c):

7 per centum of the portion of the undistributed net income which is not in excess of 10 per centum of the adjusted net income.

12 per centum of the portion of the undistributed net income which is in excess of 10

per centum and not in excess of 20 per centum of the adjusted net income.

17 per centum of the portion of the undistributed net income which is in excess of 20 per centum and not in excess of 40 per centum of the adjusted net income.

22 per centum of the portion of the undistributed net income which is in excess of 40 per centum and not in excess of 60 per centum of the adjusted net income.

27 per centum of the portion of the undistributed net income which is in excess of 60 per centum of the adjusted net income.

* * * * *

SEC. 22. GROSS INCOME.

(a). *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

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SEC. 26. CREDITS OF CORPORATIONS.

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

* * * * *

(c) *Contracts Restricting Payment of Dividends.*—

(1) *Prohibition on payment of dividends.*—An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. If a corporation would be entitled to a credit under this paragraph because of a contract provision and also to one or more credits because of other contract provisions, only the largest of such credits shall be allowed, and for such purpose if two or more credits are equal in amount only one shall be taken into account.

* * * * *

Section 22 (a), Revenue Act of 1938 c. 289, 52 Stat. 447, is the same as the corresponding section of the Revenue Act of 1936.

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 26-2. *Credit in connection with contracts restricting payment of dividends.*— * * *

* * * * *

(b) *Prohibition on payment of dividends.*—The credit provided in section 26 (c)(1) is allowable only with respect to a written contract executed by the corporation prior to May 1, 1936, which expressly deals with the payment of dividends and operates as a legal restriction upon the corporation as to the

amounts which it can distribute within the taxable year as dividends. If an amount can be distributed within the taxable year as a dividend—

(1) in one form (as, for example, in stock or bonds of the corporation) without violating the provisions of a contract, but can not be distributed within the taxable year as a dividend in another form (as, for example, in cash) without violating such provisions, or

(2) at one time (as, for example, during the last half of the taxable year) without violating the provisions of a contract, but can not be distributed as a dividend at another time within the taxable year (as, for example, during the first half of the taxable year) without violating such provision—

then the amount is one which, under section 26 (c) (1), can be distributed within the taxable year as a dividend without violating such provisions.

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